Improving Individual Retirement Savings Outcomes
In Defined Contribution Savings Plans

Remarks by

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Prepared for the Hearing

"Pension Savings: Are Workers Saving Enough"

COMMITTEE ON HEALTH, EDUCATION, LABOR AND PENSIONS

Thursday, January 31, 2013

There is much concern in both academic and policy circles about whether our current private defined contribution retirement savings system can adequately meet the retirement income needs of individuals. Although the current system has several shortcomings, there are sensible steps that that can be taken to improve outcomes for individuals without increasing the costs or risks to employers.

Increasing the Coverage of Employer Sponsored Retirement Savings Plans

The first shortcoming of the current system is participation: less than half of private sector workers participate in an employer-sponsored retirement plan.[i] This is not such a big problem in medium and large firms. Most such firms offer a retirement savings plan and have been quick to adopt automatic enrollment so that participation rates are relatively high. It is a much bigger problem in small firms which are less likely to offer a retirement savings plan and, if they do, are much less likely to use automatic enrollment.

Policy initiatives that encourage and facilitate the automatic savings of employees in small firms are a key step to increasing participation and improving outcomes in a defined contribution retirement savings system. Two such proposals are the widely endorsed Automatic IRA and the U.S. Senate HELP committee's USA Retirement Funds.[ii] Both would create a simple and low cost mechanism for small employers to make contributions to retirement savings accounts for their employees through payroll deduction.

Increasing Employee Retirement Savings Contributions

The second shortcoming of the current system is that those workers who do participate in a defined contribution retirement savings plan too often have contribution rates that are too low. Savings plans need to be structured to encourage higher participant contributions. Let me suggest three easy ways to do so.

(1) In most defined contribution savings plans, employees designate their contributions as a percent of pay. In these plans, the contribution rates that employees choose tend to be either multiples of 5 (e.g., 5%, 10% or 15%), the rate that maxes out the employer match, or the maximum rate allowed by the plan. In most plans, the most popular contribution rate is the match threshold, the rate that maxes out the employer match. This makes the match threshold an important lever in determining how much employees save.

    A typical savings plan employer match is 50% up to 6% of pay. Such a match costs the employer 3% of pay for every employee contributing at or above the 6% match threshold and gives employees a financial incentive to save at least 6% of pay.

Consider now a match of 30% up to 10% of pay. Such a match would cost the employer 3% of pay for every employee contributing at or above the 10% match threshold. This match gives employees a financial incentive to save at least 10% of pay but at no increased cost to the employer.

Encouraging employers to change the structure of their employer match to provide a financial incentive for employees to save more is an easy way to increase employee retirement savings plan contributions.

(2) Encourage employers to adopt a higher default contribution rate under automatic enrollment. The typical automatic enrollment default contribution rate is 3%. For most people, this falls well short of what they need to save to fund their retirement, yet we know from extensive research that many employees will persist at the default. The solution is easy—set a higher default contribution rate. One concern that employers voice about doing so is that a higher default contribution rate will encourage more employees to opt-out of savings plan participation altogether which would circumvent the primary goal of automatic enrollment which is high participation. In my own research, I have found that few employees object to higher automatic enrollment default contributions rates of 5% or 6% in companies that match at least to that level.

(3) More aggressive automatic contribution escalation. The Pension Protection Act of 2006 provides a non-discrimination testing safe harbor for plans that adopt automatic enrollment with a 3% default contribution rate in conjunction with automatic contribution escalation of 1% a year until employees are saving at least 6% of pay. A more aggressive approach would be an initial default of 5% or 6% of pay coupled with automatic contribution escalation of 1% a year until employees are saving 10%. If employees don't opt out of these defaults, the latter approach would generate 67% more in retirement wealth accumulation than the Pension Protection Act baseline. Even though the Pension Protection Act automatic contribution increase baseline calls for a 1% increase each year, there is no reason that employers could not escalate employee contributions more quickly, say, at 2% or even 3% a year, always allowing employees to opt out to a slower rate of escalation or none at all if a 2% of 3% increase seems beyond their reach. Research shows that few employees opt out of contribution escalation even with more aggressive annual increases, and this can be a very effective way to quickly move employees to a contribution rate that could reasonably be expected to meet their retirement income needs.

Note that the combination of these approaches could be particularly powerful. Suppose that a company adopted a match of 30% of contributions up to 10% of pay in combination with automatic enrollment with a default contribution rate of 6% along with automatic contribution increases of 2% a year up to 10% of pay. In their first two years on the job, new employees who persist at the default would move from saving 6% to 8% to 10% of their own pay; moreover, they would have a financial incentive through the employer match to want to reach a savings rate of at least 10% of pay; if you layer the employer match on top of this, their total savings, including the employer match, would increase from 7.8% to 10.4% to 13% of pay in their first two years. In contrast, an employee at a firm with a typical match of 50% up to 6% of pay and with automatic enrollment and automatic contribution increases that comply with the Pension Protection Act minimum standards would only reach a much lower maximum combined employee/employer contribution rate of 9% of pay after three years on the job.

Reducing the Impact of Leakage from the Retirement Savings System

A third shortcoming of the current system is leakage: many individuals take money out of their account before retirement for other purposes, and that money is subsequently not available to fund retirement. This is a serious problem and one that has largely been under the radar the screen. Recent studies by the GAO, by employees at the Federal Reserve and the IRS, and by the private company Hello Wallet, all estimate that there is a sizeable amount of leakage from the retirement savings system, most significantly due to pre-retirement cash distributions after employees change jobs. Moreover, survey results from Fidelity Investments and the Boston Research Group find that 55% of employees who have taken a pre-retirement cash distribution from their defined contribution savings plan later regret having done so.

The reality is that defined contribution savings plans are not used solely to fund retirement; for many, they serve as an all-purpose savings vehicle that is frequently tapped before retirement for other reasons. Because of this, the “recommended” contribution rate to these accounts should reflect not only what is needed to successfully fund retirement, but what will in all likelihood be withdrawn from the plan before retirement as well. Retirement savings calculators designed to help individuals determine how much they need to save for retirement will understate how much actually needs to be saved if the calculators don’t account for the fact that some portion of the money that is contributed will in fact be withdrawn and unavailable at the time of retirement.

This suggests that policy should either encourage contribution rates that are above those needed solely to fund retirement, or policy should limit the extent to which individuals can take pre-retirement distributions from these accounts.

Turning Retirement Wealth into Retirement Income

A final shortcoming of the current system is that most employer savings plans do not offer employees an easy way to transform their retirement wealth into retirement income through an annuitization option. If retirees want an annuitized income stream, they are left to contend with the private market on their own, trying to evaluate a product with which they have little experience and whose purchase will consume a substantial fraction of their wealth. The end result is that annuitization rates are very low. Employers provide several valuable services to their employees which it comes to the investment options in their savings plans: they evaluate the many available alternatives and select the few options that are best suited to their employees' needs, and they are able to offer employees lower cost investment options than the employees would have access to individually through economies of scale. Having employers perform the same function for retirement income options would be a valuable service to many current and former employees, but employers currently have little incentive to do so.

Conclusion

Our defined contribution retirement savings system is not perfect, but there are several things we can do to make it substantively better. First, we can increase coverage by creating an easy and low cost mechanism for small employers to use so that employees at these firms can benefit from payroll deductions that go straight into a retirement savings account. Second, we can encourage employers to structure their savings plans in ways that promote higher employee contribution rates. Third, we can limit leakage from retirement savings plans. And fourth, we can encourage the adoption of in plan annuitization options.

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[i] Alica Munnell (2012). "401(k) Plans in 2010: An Update from the SCF." Center for Retirement Research Working Paper Number 12-13 (July 2012). < http://crr.bc.edu/wp-content/uploads/2012/07/IB_12-13.pdf , accessed January 29, 2013>

[ii] See J. Mark Iwry and David John (2009), "Pursuing Universal Retirement Security through Automatic IRAs." Retirement Security Project Working Paper 2009-3, <http://www.brookings.edu/~/media/research/files/papers/2009/7/automatic%20ira%20iwry/07_automatic_ira_iwry.pdf, accessed January 29 2013>, and U.S. Senate Committee on Health, Education, Labor and Pensions (2012), "The Retirement Crisis and a Plan to Solve It," < http://www.harkin.senate.gov/documents/pdf/5011b69191eb4.pdf, accessed January 29, 2013>.